

AN AUDIT

State Life Insurance Fund

Office of the Commissioner of Insurance

99-20

December 1999

1999-2000 Joint Legislative Audit Committee Members

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December 13, 1999

Senator Gary R. George and
Representative Carol Kelso, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator George and Representative Kelso:

We have completed an audit of the financial statements of the State Life Insurance Fund for the period January 1, 1996 through December 31, 1998, as required by s. 13.94 (1)(de), Wis. Stats. The Fund, which was created in 1911 to provide low-cost life insurance policies to Wisconsin residents, is administered by the Office of the Commissioner of Insurance. As of December 31, 1998, the Fund had 31,033 life insurance policies in effect, and total life insurance in force of approximately \$226 million. The Fund is subject to the same regulatory requirements as any life insurance company licensed to operate in Wisconsin, as well as to other specific statutory restrictions, such as a prohibition on advertising and maximum coverage to any insured person of \$10,000.

The State Life Insurance Fund prepares its financial statements using insurance accounting practices prescribed by the Commissioner of Insurance. We found the regulatory-based financial statements to be fairly presented in accordance with these accounting practices.

The Fund, which is self-funded through premiums and investment earnings, returned between \$3.6 million and \$3.8 million to policyholders as dividends in each of the three years we audited. Statutes require that any fund surplus that accumulates be maintained at a level between 7 and 10 percent of fund assets, so far as is practically possible. The Fund's surplus-to-asset ratio was 10.1 percent as of December 31, 1998, which slightly exceeds the statutory range.

We appreciate the courtesy and cooperation extended to us by the staff of the Office of the Commissioner of Insurance.

Respectfully submitted,

Janice Mueller
State Auditor

JM/DA/ao

INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS OF THE WISCONSIN STATE LIFE INSURANCE FUND

We have audited the accompanying balance sheet—regulatory basis of the Wisconsin State Life Insurance Fund as of December 31, 1998, December 31, 1997, and December 31, 1996, and the related statements of operations and changes in fund surplus—regulatory basis and cash flows—regulatory basis for the years then ended. These financial statements are the responsibility of the management of the State Life Insurance Fund. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements present only the State Life Insurance Fund and are not intended to present fairly the financial position of the State of Wisconsin and the results of its operations and changes in financial position of its proprietary fund types in conformity with general accepted accounting principles.

As described more fully in Note 2, the State Life Insurance Fund prepares these financial statements using accounting practices prescribed or permitted by the Commissioner of Insurance of the State of Wisconsin, which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between the regulatory basis of accounting and generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of the State Life Insurance Fund as of December 31, 1998, December 31, 1997, and December 31, 1996, or the results of its operations or its cash flows for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Life Insurance Fund as of December 31, 1998, December 31, 1997, and December 31, 1996, and the results of its operations and changes in fund surplus and its cash flows for the years then ended on the basis of accounting described in Note 2.

In accordance with *Government Auditing Standards*, we also will issue a report dated December 3, 1999 on our consideration of the State Life Insurance Fund's internal control over financial reporting, and on our tests of its compliance with certain provisions of laws, regulations, and contracts.

LEGISLATIVE AUDIT BUREAU

December 3, 1999

by

Diann Allsen
Financial Audit Director

Office of the Commissioner of Insurance
Wisconsin State Life Insurance Fund
Balance Sheet - Regulatory Basis
December 31, 1998, December 31, 1997, and December 31, 1996

	<u>12/31/98</u>	<u>12/31/97</u>	<u>12/31/96</u>
Assets			
Investments:			
Bonds and private placements	\$ 58,020,924	\$ 56,549,437	\$ 54,039,967
Policy loans	3,845,293	3,788,432	3,721,951
Total Investments	61,866,217	60,337,869	57,761,918
Cash and Cash Equivalents	5,476,318	4,546,566	4,437,367
Premiums Receivable	127,499	132,847	143,399
Investment Income Receivable	1,358,535	1,371,130	1,396,470
Amounts Recoverable From Reinsurers	6,854	0	0
Total Assets	<u>\$ 68,835,423</u>	<u>\$ 66,388,412</u>	<u>\$ 63,739,154</u>
Liabilities and Fund Surplus			
Liability for Future Benefits:			
Life insurance policies and contracts	\$ 47,449,181	\$ 45,918,948	\$ 44,325,803
Supplementary contracts without life contingencies	325,501	318,280	243,850
Total Liability for Future Benefits	47,774,682	46,237,228	44,569,653
Policy Claims Payable	120,000	118,000	77,500
Dividends Left to Accumulate with Interest	8,199,455	7,793,507	7,106,800
Dividends Due and Unpaid, Plus Those Payable in the Following Year	3,727,235	3,686,429	3,819,344
Accrued Deposits	1,224,133	1,144,987	1,067,731
Premiums Received in Advance	36,748	44,069	41,524
General Expenses and Taxes Payable	118,541	69,413	80,626
Interest Maintenance Reserve	355,997	330,029	180,205
Asset Valuation Reserve	228,383	252,144	550,436
Other Liabilities	97,596	87,174	110,705
Total Liabilities	61,882,770	59,762,980	57,604,524
Fund Surplus	6,952,653	6,625,432	6,134,630
Total Liabilities and Fund Surplus	<u>\$ 68,835,423</u>	<u>\$ 66,388,412</u>	<u>\$ 63,739,154</u>

The accompanying notes are an integral part of this statement.

Office of Commissioner of Insurance
Wisconsin State Life Insurance Fund
Statement of Operations and Changes in Fund Surplus - Regulatory Basis
for Years Ended December 31, 1998, December 31, 1997, and December 31, 1996

	Year Ended 12/31/98	Year Ended 12/31/97	Year Ended 12/31/96
Revenues			
Premiums and Annuity Considerations	\$ 2,703,620	\$ 2,830,780	\$ 3,029,197
Considerations for Supplemental Contracts and Dividend Accumulations	860,247	924,825	818,267
Net Investment Income	4,937,865	4,901,782	4,940,152
Amortization of Interest Maintenance Reserve	42,029	41,904	45,840
Miscellaneous Income	7,775	2,166	1,506
Total Revenues	8,551,536	8,701,457	8,834,962
Operating Expenses			
Benefits:			
Death benefits	677,512	654,974	618,801
Matured endowments	376,000	382,000	463,000
Disability benefits	9,977	11,646	11,385
Surrender benefits	330,321	343,924	300,671
Interest on policy or contract funds	66,798	61,237	59,713
Payments on supplementary contracts and dividend accumulations	722,506	653,720	700,194
Increase in aggregate liability for future benefits and payments	1,943,402	2,354,280	2,150,166
Total Benefits	4,126,516	4,461,781	4,303,930
General Expenses	468,339	434,523	491,773
Total Operating Expenses	4,594,855	4,896,304	4,795,703
Net Income from Operations before Dividends and Realized Capital Gains	3,956,681	3,805,153	4,039,259
Dividends to Policyholders	(3,653,012)	(3,612,528)	(3,769,456)
Realized Capital Gains (Losses)	(89)	0	3,679
Net Income	\$ 303,580	\$ 192,625	\$ 273,482
Changes in Fund Surplus			
Surplus at Beginning of Period	\$ 6,625,432	\$ 6,134,630	\$ 6,665,950
Prior-Period Adjustment	0	0	(829,227)
Adjusted beginning surplus	6,625,432	6,134,630	5,836,723
Net Income	303,580	192,625	273,482
Change in Asset Valuation Reserve	23,761	298,292	24,287
Other Items Affecting Surplus	(120)	(115)	138
Net change in surplus account	327,221	490,802	297,907
Surplus at End of Period	\$ 6,952,653	\$ 6,625,432	\$ 6,134,630

The accompanying notes are an integral part of this statement.

Office of the Commissioner of Insurance
Wisconsin State Life Insurance Fund
Cash Flows Statement - Regulatory Basis
for Years Ended December 31, 1998, December 31, 1997, and December 31, 1996

	Year Ended <u>12/31/98</u>	Year Ended <u>12/31/97</u>	Year Ended <u>12/31/96</u>
Cash Provided from Operating Activities			
Premium and Annuity Considerations	\$ 2,700,242	\$ 2,845,473	\$ 3,033,151
Other Premiums Considerations and Deposits	860,247	924,825	818,267
Net Investment Income	4,955,683	4,922,328	4,837,157
Decrease (Increase) in Policy Loans	(56,861)	(66,481)	23,672
Other Income Received	95,943	54,435	(44,819)
Total Receipts	<u>8,555,254</u>	<u>8,680,580</u>	<u>8,667,428</u>
Life Policy Claims Paid	1,068,343	1,008,120	1,129,186
Surrender Benefits Paid	330,321	343,924	300,671
Other Benefits Paid	722,506	653,720	700,194
Interest on Policy or Contract Funds	65,517	59,893	58,750
Total Benefits Paid	<u>2,186,687</u>	<u>2,065,657</u>	<u>2,188,801</u>
General Expenses and Taxes Paid	417,823	447,329	426,729
Dividends Paid	3,612,206	3,745,443	3,668,773
Prior-Year Service Fees Paid	0	0	829,227
Total Expenses Paid	<u>6,216,716</u>	<u>6,258,429</u>	<u>7,113,530</u>
Net Cash Provided by Operating Activities	<u>2,338,538</u>	<u>2,422,151</u>	<u>1,553,898</u>
Cash Provided from Investing Activities			
Cash Received from Sale of Bonds	8,354,694	4,632,000	3,166,125
Cash Paid for Purchase of Bonds	(9,763,480)	(6,944,952)	(6,094,573)
Net Cash Used by Investing Activities	<u>(1,408,786)</u>	<u>(2,312,952)</u>	<u>(2,928,448)</u>
Net Change in Cash and Cash Equivalents	929,752	109,199	(1,374,550)
Cash and Cash Equivalents at January 1	<u>4,546,566</u>	<u>4,437,367</u>	<u>5,811,917</u>
Cash and Cash Equivalents at December 31	<u>\$ 5,476,318</u>	<u>\$ 4,546,566</u>	<u>\$ 4,437,367</u>

The accompanying notes are an integral part of this statement.

NOTES TO THE FINANCIAL STATEMENTS

1. Description of the Fund

The State Life Insurance Fund, which is part of the State of Wisconsin financial reporting entity and is reported as an enterprise fund in the State's Comprehensive Annual Financial Report, was created in 1911 to provide life insurance policies to Wisconsin residents at the lowest possible cost. The Fund is administered by the Office of the Commissioner of Insurance.

The Fund's operation is similar to that of a mutual life insurance company, and the Fund is subject to the same regulatory requirements as any life insurance company licensed to operate in Wisconsin. The Fund is also subject to other specific statutory restrictions, such as a prohibition on advertising and a maximum coverage of \$10,000, that limit the competitive advantage the Fund may have over private insurance companies. The Fund offers two basic policies: whole life insurance and term insurance. As of December 31, 1998, the Fund had 31,033 life insurance policies in effect.

2. Basis of Presentation

The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the State of Wisconsin's Commissioner of Insurance and vary in some respects from generally accepted accounting principles. The most significant differences are included in the following table:

<u>Financial Statement Area</u>	<u>Regulatory Accounting Practices</u>	<u>Generally Accepted Accounting Principles</u>
Bond valuation	Amortized cost, except for certain bonds that are reported at a value stipulated by the National Association of Insurance Commissioners (NAIC).	Fair value
Asset valuation reserve	Established as a buffer against fluctuating asset prices caused by changes in the credit quality of the investment portfolio. Changes are charged directly to surplus.	Not applicable
Interest maintenance reserve	Established as a buffer against realized gains and losses caused by general interest rate changes. Changes are amortized to income.	Not applicable

Unrealized investment gains (losses)	Recorded directly to surplus.	Recorded in income.
Liability for future benefits	Determined using valuation methods and assumptions prescribed by the Commissioner of Insurance.	Determined using interest, mortality, and withdrawal assumptions based on actual and expected experience.
Due and deferred premiums	Recorded as assets.	Due premiums reported as assets; deferred premiums offset against liabilities for future policy benefits.
Dividends	Provision made for dividends payable on next contract anniversary in the following year.	Provision made for accumulated earnings expected to be paid to policyholders, including pro rata portion of dividends incurred to valuation date.
Contract acquisition costs	Charged to expense in current operations when incurred.	Deferred and amortized in relation to the premium revenue recognized.

3. Basis of Valuation of Invested Assets

Investments are carried at values on the following bases:

- all mortgage-backed securities are carried at amortized cost using the prospective scientific method. All other bonds are carried at amortized cost using the straight-line method of amortization, except for NAIC category bonds, which are carried at a value stipulated by NAIC;
- policy loan values are at outstanding indebtedness, not in excess of policy cash surrender value; and
- investments in the State Investment Fund, which are reported as cash equivalents, are carried at the cost of the participating shares, which is also the realizable value as of December 31. Interest income, gains, and losses of the State Investment Fund are allocated monthly.

4. Deposits and Investments

All cash is deposited with the State of Wisconsin Treasurer and is invested by the State of Wisconsin Investment Board through the State Investment Fund, a short-term pool of state and local funds managed by the State of Wisconsin Investment Board with oversight by its Board of Trustees as authorized in ss. 25.14 and 25.17, Wis. Stats. The State Investment Fund is not registered with the Securities and Exchange Commission as an investment company. Shares in the State Investment Fund are reported as cash equivalents. The various types of securities in which the State Investment Fund may invest are enumerated in ss. 25.17(3)(b), (ba), and (bd), Wis. Stats., and include direct obligations of the United States and Canada; securities guaranteed by the United States; securities of federally chartered corporations, such as the African Development Bank; unsecured notes of financial and industrial issuers; Yankee/Eurodollar issues; certificates of deposit issued by banks in the United States and solvent financial institutions in this state; and bankers acceptances.

The State Life Insurance Fund's investments are managed by the Investment Board with an investment objective to maintain a diversified portfolio of high-quality income obligations that will preserve principal, maximize income while minimizing costs to policyholders, and approximate the expected life of the Fund's insurance contracts. The Fund's investments include public bonds and privately negotiated fixed-income securities, which consist of U.S. Government obligations; other state, territory, or possession obligations; and public utility, railroad, industrial, and miscellaneous corporate obligations. The book values and market values of the Fund's investments as of December 31, 1998, are shown as follows:

<u>Public Bonds</u>	<u>Book Value</u>	<u>Market Value</u>
Government:		
Not backed by loans	\$20,095,249	\$23,232,500
Backed by loans	<u>1,618,762</u>	<u>1,691,347</u>
Total Government	21,714,011	24,923,847
Utilities	4,912,926	5,238,178
Industrials and Others	<u>10,784,644</u>	<u>11,313,370</u>
Total Bonds	<u>37,411,581</u>	<u>41,475,395</u>
<u>Private Placements</u>		
Government—Backed by Loans	164,496	179,523
Utilities	1,833,156	2,000,935
Industrials and others	<u>18,611,691</u>	<u>20,314,019</u>
Total Private Placements	<u>20,609,343</u>	<u>22,494,477</u>
Total	\$58,020,924	\$63,969,872

The State Life Insurance Fund's deposits are insured or collateralized with securities held by the State or by its agent in the State's name. The Fund's bonds are insured or registered, or are held by the State or its agent in the State's name.

5. Net Investment Income

Net investment income for calendar years 1998, 1997, and 1996 consisted of the following components:

	<u>1998</u>	<u>1997</u>	<u>1996</u>
Bonds and private placements	\$4,439,117	\$4,387,527	\$4,411,743
Policy loans	231,927	265,989	242,553
State Investment Fund	<u>328,621</u>	<u>293,666</u>	<u>309,056</u>
Subtotal	4,999,665	4,947,182	4,963,352
Less investment expenses	<u>61,800</u>	<u>45,400</u>	<u>23,200</u>
Net Investment Income	\$4,937,865	\$4,901,782	\$4,940,152

6. Interest Maintenance Reserve

The interest maintenance reserve (IMR) accumulates interest-related realized gains and losses and amortizes them into income over the remaining life of the investments sold. The State Life Insurance Fund uses the IMR method that amortizes groups of assets based on the average maturity dates using standard amortization tables developed by NAIC.

7. Premiums and Annuity Considerations

Premium revenues are reported as earned on the policy anniversary date. Related expenses are recognized when incurred.

As of December 31, deferred and uncollected life insurance premiums and annuity considerations, all of which were for ordinary life insurance, were:

	<u>1998</u>	<u>1997</u>	<u>1996</u>
Gross premium	\$161,099	\$165,043	\$177,191
Premium net of loading	\$127,499	\$132,847	\$143,399

Gross premium is the premium charged to the policyholder. Net premium is the amount of premium used in the calculation of the statutory reserves and represents the amount needed to provide contract benefits based on statutory

interest and mortality reserve assumptions. Loading refers to the difference between the gross and net premium and represents the amount available for expenses.

8. Reinsurance

The State Life Insurance Fund has a reinsurance contract with Lincoln National Life Reinsurance Company for insuring those applicants considered high risk by the Fund. Under this reinsurance agreement, the Fund retains the reserves and related assets; pays the reinsurer premiums for the ceded business; and is reimbursed for benefits, unusual expenses, and adjustments to required reserves. The reinsurer has no obligation for the reimbursement of dividends related to the ceded business.

As of December 31, 1998, total life insurance in force was approximately \$225.96 million, of which \$2.69 million had been ceded. The Fund is contingently liable with respect to ceded insurance should the reinsurer be unable to meet its assumed obligations.

Revenues received from the reinsurer are treated as a reduction of benefit expense; payments to the reinsurer are treated as a reduction of premium income. Reinsurance transactions reported in the Fund's operations include \$26,988 in claims incurred and \$32,498 in premiums earned in 1998; \$14,026 in claims incurred and \$34,376 in premiums earned in 1997; and \$3,896 in claims incurred and \$37,619 in premiums earned in 1996.

9. Liability for Future Benefits

Insurance liabilities for future benefits for policies issued prior to 1977 are determined in accordance with the Net Level Premium Method, using the American Experience or 1958 Commissioners Standard Ordinary (CSO) mortality tables and an interest rate of 3 percent. Reserves for policies issued between 1977 and 1986 are based on the Commissioners Reserve Valuations Method, using the 1958 CSO mortality tables and an interest rate of 4 percent. Reserves for policies issued between 1986 and 1994 are based on a modified version of the Commissioners Reserve Valuations Method, using the 1980 CSO mortality tables and an interest rate of 5 percent. Reserves for policies issued since January 1, 1995, are based on the Commissioners Reserve Valuations Method, using the 1980 CSO mortality tables and an interest rate of 4 percent.

The Fund waives deduction of deferred fractional premiums upon the death of the insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.

The Fund cedes 100 percent of the risk on substandard policies to its reinsurer. The Fund holds the standard reserve in its financial statements and does not take reserve credits relating to the reinsurance. Therefore, actual reserves held by the Fund for substandard lives exceed the minimum reserve that is required for such policies.

The State Life Insurance Fund had the following amounts of insurance in force for which gross premiums were less than net premiums according to the standard valuation set by the State of Wisconsin, and the following amounts of reserves to cover this deficiency were included in the liability for future benefits as of December 31, 1998, 1997, and 1996:

	<u>December 31, 1998</u>	<u>December 31, 1997</u>	<u>December 31, 1996</u>
Insurance in force for which gross premiums are less than net premiums	\$9.7 million	\$10.3 million	\$10.9 million
Reserves included in liability for future benefits to cover deficiency	\$88,862	\$98,503	\$107,695

10. Deposit Fund Liabilities

Deposit fund liabilities for the Fund, which are subject to discretionary withdrawal without adjustment, are reported at book value and are not affected by reinsurance. The liability accounts reported for calendar years 1998, 1997, and 1996 include:

	<u>1998</u>	<u>1997</u>	<u>1996</u>
Supplementary contracts without life contingencies	\$ 325,501	\$ 318,280	\$ 243,850
Dividends left to accumulate	8,199,455	7,793,507	7,106,800
Accrued deposits	<u>1,224,133</u>	<u>1,144,987</u>	<u>1,067,731</u>
Total deposit fund liabilities	\$9,749,089	\$9,256,774	\$8,418,381

11. Dividend Restrictions

One hundred percent of policies are participating. Dividends payable in the following year are charged to current operations, with 25 percent of the payable amount apportioned for payment between January 1 and March 31. The apportioned amount was \$915,440 for 1998, \$972,918 for 1997, and \$947,660 for 1996.

Section 607.15, Wis. Stats, requires that the surplus be maintained at a level between 7 and 10 percent of assets, as far as is practically possible. The dividend formula was last changed in 1998, primarily to comply with illustrative NAIC

regulations requiring an accurate reflection of investment earnings, to incorporate service fees paid to the Wisconsin Department of Administration, and to reflect gains made due to favorable mortality. This change resulted in a decrease in dividends paid out. The Fund's surplus-to-asset ratio was 10.1 percent as of December 31, 1998.

12. Claims Payable

The liability for unpaid claims includes reported claims that were not paid at year-end, and estimates of claims that were incurred but not reported, based on claims reported in January.

13. Employee Retirement Plan

Permanent, full-time employees of the State Life Insurance Fund are participants in the Wisconsin Retirement System, a cost-sharing, multiple-employer, defined benefit plan governed by Chapter 40 of Wisconsin Statutes. State and local government public employees are entitled to an annual formula retirement benefit based on: 1) the employee's final average earnings; 2) years of creditable service; and 3) a formula factor. If an employee's contributions, matching employer's contributions, and interest credited to the employee's account exceed the value of the formula benefit, the retirement benefit may instead be calculated as a money purchase benefit. The Wisconsin Retirement System is considered part of the State of Wisconsin's financial reporting entity. Copies of the separately issued financial report that includes financial statements and required supplementary information for the year ending December 31, 1998, may be obtained by writing to:

Department of Employee Trust Funds
P.O. Box 7931
Madison, WI 53707-7931

Generally, the State's policy is to fund retirement contributions on a level-percentage-of-payroll basis to meet normal and prior service costs of the retirement system. Prior service costs are amortized over 40 years, beginning January 1, 1990. The retirement plan requires employee contributions equal to specified percentages of qualified earnings based on the employee's classification, plus employer contributions at a rate determined annually. The relative position of the State Life Insurance Fund in the Wisconsin Retirement System is not available, since the System is a statewide, multiple-employer plan.

14. Prior-Period Adjustment

Section 607.21(4). Wis. Stats., requires that an annual fee be paid to the Wisconsin Department of Administration equal to 2 percent of net premiums collected for general services rendered by state agencies and otherwise not

charged to the Fund. During 1996, the State Life Insurance Fund paid \$829,227 for prior years' service fees, based on a revised method required by the Department of Administration for determining net premiums for the previous 16 years. The prior-years' service fees are reported as an adjustment to the beginning surplus as of January 1, 1996.

15. Audit Adjustments

The unaudited financial statements presented in the Commissioner of Insurance's annual reports to the Governor and the Legislature have been adjusted to reflect recommended audit adjustments.
